COMPLEX TRUST TAXATION: A PROPOSED REFORM

Complex trusts,[1] treated ostensibly as separate taxable entities,[2] are accorded hybrid treatment by the Internal Revenue Code of 1954.[3] They are taxed as individuals at the same rates as married taxpayers filing separately.[4] In computing taxable income, however, unlike other taxable entities, trusts are afforded a deduction for amounts distributed or required to be distributed during the taxable year to beneficiaries.[5] These amounts must be included in the beneficiary's income for the year distributed[6] and retain in his hands the same character as in the hands of the trust.[7] Thus, income earned by a trust is taxed only once.[8] Income distributed in the year earned is taxed to the beneficiary receiving it,[9] and earned income not distributed—accumulated—is taxed to the trust.

Hybrid treatment presents significant opportunities for tax avoidance. Because income destined for the hands of a beneficiary may be retained by a trust and taxed to it, the beneficiary's income may effectively be split between him and the trust and the effects of the progressive income tax thus mitigated.[10] Further, so long as the trust's income

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1 The Internal Revenue Code of 1954 does not actually define the terms simple and complex. Simple trusts are those which by their terms are required to distribute all income currently, while complex trusts are those which may either distribute or accumulate current income. *Compare* INT. REV. CODE of 1954, §§ 651, 652 (simple trusts) [hereinafter cited as IRC], *with* IRC §§ 661-69 (complex trusts). *See also* Holland, Kennedy, Surrey, & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft*, 53 COLUM. L. REV. 316, 350-54 (1953) [hereinafter cited as Holland]; Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 COLUM. L. REV. 1237, 1238 & n.4, 1239-40 (1954) [hereinafter cited as Kamin].

2 IRC § 641.

3 *Id.* §§ 641-83.

4 *Id.* § 1(d).

5 *Id.* §§ 651, 661.

6 *Id.* §§ 61(a)(15), 652, 662. *But see id.* § 663. The Supreme Court held in Irwin v. Gavit, 268 U.S. 161 (1925), that income from trust property distributed currently to a beneficiary did not come within the exemption for gifts. The current Code contains a similar provision. IRC § 102(b).

7 IRC §§ 652(b), 662(b).

8 Of course, neither the trust nor the beneficiaries will be taxed on income exempt from taxation, such as municipal bond interest. *See id.* §§ 103(a), 643(a), 651, 652, 661, 662.

9 *Id.* §§ 652(a), 662(a); *see id.* §§ 652(b), 662(b).

10 Similarly, multiple trusts could be utilized to minimize income taxes through income splitting. Several trusts, each paying taxes at the lowest marginal rates, could be set up for the benefit of the same beneficiary or beneficiaries. The total taxes at these lower rates are less than the taxes which would be paid if one trust reported all the income and was taxed at the higher marginal rates. Multiple trusts still pose significant tax deferral problems, which the reform proposed in this Comment would eliminate. *See, e.g.,* Estelle Morris Trusts, 51 T.C. 20 (1968), *aff'd per curiam,* 427 F.2d 1361 (9th Cir. 1970).

Multiple trusts are open to attack by the Internal Revenue Service as being shams; if successfully attacked, the trusts would be treated as one for income tax purposes.

results in a marginal tax rate lower than that of the beneficiary, additional accumulation of income in the trust will produce even greater tax savings.[11]

The Code's "throwback rule" is an attempt to eliminate this tax-saving technique by requiring anyone receiving accumulations distributions to recompute his income and tax for the years in which income earned by the trust was accumulated. This Comment will examine the throwback rule as originally enacted and as changed by the Tax Reform Act of 1969,[12] and the problems these attempts to deal with complex trusts have imported into the present system.[13] Finding two major problems—extensive recordkeeping and administrative requirements, and opportunities for calculated tax deferral—the suggestion will be made that the costs, to taxpayers who bear the administrative burden and to the Government which loses revenue, do not justify the added certainty provided by the wait-and-see approach of the throwback rule. Accordingly, after examining the apparent alternatives, the Comment will propose that trusts be taxed currently at a rate determined by attributing proportionally to the trust the rates of those beneficiaries most likely to receive the income according to the information available at the end of the tax year.

I. Present Law: The Throwback Rule

A. *1954 Code Before the Tax Reform Act of 1969*

In general, distributions to income beneficiaries fall within one of three categories and, under the pre-1969 throwback rule, were deemed to have been made in the following order:[14] (1) distributions actually made or required to be made from the trust's current income; (2) distributions from that portion of trust income in previous years which was not required to be and was not distributed; and (3) distributions from trust corpus. Distributions made or required to be made from

[11] It is possible for a trust to be in a higher marginal rate bracket than the trust's beneficiaries; Congress, however, in considering remedial measures in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, assumed that the opposite situation was more prevalent. *See* H.R. Rep. No. 413, pt. 1, 91st Cong., 1st Sess. 92-94 (1969) [hereinafter cited as H.R. Rep.]; S. Rep. No. 552, 91st Cong., 1st Sess. 124-27 (1969) [hereinafter cited as S. Rep.]

[12] Pub. L. No. 91-172, 83 Stat. 487.

[13] IRC §§ 641-92. This Comment deals principally with Part I, Subparts A, B, C, and D of Subchapter J. *Id.* §§ 641-69. For an introduction to the principles of trust taxation, see M. Egan, Jr., W. Andrews, E. Colson, G. Craven, & D. Kahn, Problems of Federal Taxation of Estates—Gifts—Trusts 151-75, 181-84 (1966); D. Kahn, E. Colson, & G. Craven, Federal Taxation of Estates, Gifts, and Trusts 247-82, 289-303, 315-34 (1970); A. Michaelson, Income Taxation of Estates and Trusts (rev. ed. 1970); Holland, *supra* note 1; Kamin, *supra* note 1.

[14] *See* IRC §§ 662(a) [O]. References to sections of the Internal Revenue Code of 1954, ch. 736, 68A Stat. 3, before amendment by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, will be indicated by [O] following the referenced section.

current trust income and distributions from trust corpus are easily handled: the former are deducted by the trust and included in income by the beneficiary, while the latter are not.[15] Accumulated income is, however, taxed to the trust at its individual tax rate and presents opportunities for tax avoidance which the throwback rule is designed to meet.

Under the throwback rule accumulated income is treated when distributed as though earned by the beneficiary. Prior to the Tax Reform Act of 1969, this recapture was limited because only distributions of accumulations attributable to the trust's prior five years' undistributed income were included in the beneficiary's gross income in the year distributed.[16] The accumulated income was attributed in reverse chronological order to each previous year until exhausted;[17] the amount thus attributed to each year was to equal the trust's distributable net income[18] for that year, plus the taxes paid by the trust, and less distributions made or required to be made during that year.[19] A beneficiary owing additional tax received a credit[20] for any taxes previously paid by the trust on accumulated income[21] and then recomputed his tax for each year affected, paying the difference between the recomputed amount and the tax originally returned.[22] Accordingly, although the distributions were taken into income in the year received, the tax on these distributions could not exceed the tax which would have been due had the distributions actually been made during the attributable years.[23]

In addition, there were five exceptions to the recapture provisions of the pre-1969 rule: (1) distributions less than $2,000 in any one taxable year;[24] (2) distributions attributable to income accumulated during the income beneficiary's minority; (3) emergency distributions; (4) distributions required by the governing instrument to be distributed at specified ages (limited to four distributions at least four years apart and to trusts in existence prior to 1954); and (5) the final distribution of trust property, if made more than nine years after the last contribution to the trust corpus.[25]

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[15] IRC §§ 102(a), 651, 652(a), 661(a), 662(a).

[16] *Id.* § 668(a) [O].

[17] *Id.* § 666(a) [O].

[18] Distributable net income, defined in § 643, is basically taxable income before the distribution deduction. It includes all tax-exempt interest reduced by any nondeductible expenses properly attributed to such interest and dividends received by the trust, but includes neither capital gains and losses unless properly attributable to trust income nor the personal exemption of § 642(b).

[19] IRC § 665(a) [O].

[20] *Id.* § 668(b) [O].

[21] *Id.* § 668(a) [O]; *see id.* § 668(b) [O].

[22] *Id.* § 668(a) [O].

[23] *Id.*

[24] *Id.* § 665(b) [O].

[25] *Id.* §§ 665(b)(1)-(4) [O].

Not only making the tax accounting for accumulations distributions complex,[26] the throwback rule, due to its five-year time limit and the above noted exceptions, created other loopholes. Most notable, merely by delaying a distribution for nine years after the grantor had made his last contribution to trust corpus, the entire distribution, except for the distributable net income of the current year, would escape taxation at the beneficiary's rate. If the trust had distributed its income for the previous five years, a large distribution in the sixth year could escape the throwback rule entirely. Moreover, significant amounts, characterized as "emergency distributions" or attributable to the beneficiary's minority, also escaped attribution. Thus, properly drawn trust instruments, giving the trustee sufficient discretion and powers to make these types of distributions at the appropriate times (as when the beneficiary was in a relatively low bracket), could minimize the income taxes on the trust income.[27]

B. *The Tax Reform Act of 1969*

The Tax Reform Act of 1969[28] attempts to remedy these shortcomings by substituting an unlimited throwback for the previous five-year rule,[29] by applying the rule in chronological order,[30] and by eliminating all exceptions. The beneficiary must include in his income all excess distributions in the year received or when properly credited to him by the trust to the same extent as would have been required had the distributions actually been made during the prior taxable year.[31]

While previous law permitted the accumulation distribution to be taxed to the beneficiary at his marginal tax rate in the year received if

[26] The mechanics of the pre-1970 rule can best be illustrated by an example. Assume that a trust had taxable income of $2,000 in 1964, $25,000 in 1965, on which it paid taxes of $400, and $7,000, respectively, and, before any distributions to beneficiaries, taxable income of $5,000 in 1966. In 1966, the current year, the trustees distribute $25,000 to the sole beneficiary of the trust. For income tax purposes, he must account for the distribution as follows:

	Amount of Undistributed Taxable Income	Taxes Deemed Distributed	Total Taxable Income
1964	2,000	400	2,400
1965	18,000	7,000	25,000
1966	5,000		5,000
	Total Taxable Income		$32,400

He must, under the pre-1970 rules, either take the $32,400 into his 1966 taxable income, or take $5,000 into 1966 income, $25,000 into 1965 income, and $2,400 into 1964 income ($7,400 must be deemed taxes distributed. *Id.* § 666(c) [O].). Of course, using the latter alternative, he must recompute his income tax for each of the three years including these additional amounts. In either event, he receives a credit for the $7,400 taxes paid by the trust. *See* notes 40-44 *infra* & accompanying text.

[27] *See, e.g.,* Fremont-Smith, *Techniques for Controlling Income Tax Consequences of Trusts and Estates and Their Beneficiaries,* 25TH INST. ON FED. TAX. 1019 (1967).

[28] Pub. L. No. 91-172, 83 Stat. 487.

[29] *Compare* IRC § 666(a) *with id.* [O].

[30] *Id.* § 666(a).

[31] *Id.* §§ 662(a), 668(a).

he so chose,[32] the Act requires accumulated income distributions be treated as if they had been distributed in the year earned.[33] Under the "exact" method, the tax is computed, as before, at the same marginal rates that would have applied had the income been distributed rather than accumulated.

The Act provides an alternative[34] to this "exact" method—the "shortcut" method[35]—designed to eliminate extensive computations and recordkeeping.[36] Under the shortcut method the beneficiary first determines the number of years to which an accumulation distribution is attributable. From this he calculates an average yearly accumulation distribution, includes this average amount in his income for each of the three years preceding the year of distribution,[37] and computes the additional tax attributable to this amount for each of the three years. From the yearly taxes so determined he obtains the average yearly tax increase attributable to the accumulation distribution and multiplies this average by the number of years to which the distribution is attributable to determine the total tax liability attributable to the distribution.[38] Any year in the entire period of accumulation for which the amount deemed to have been distributed is less than twenty-five percent of the average yearly distribution, however, is excluded and the total accumulation distribution is divided by the remaining number of years.[39]

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32 *Id.* § 668(a) [O] (by implication); *see* text accompanying notes 16-22 *supra.*

33 IRC § 668(b)(1)(A).

For a discussion of the changes made by the Act, see Elting, *New Income Tax Rules for Accumulation Trusts With Some Drafting Suggestions,* 24 TAX LAW. 453 (1971).

34 The committee reports refer to these two methods as alternatives from which the taxpayer-beneficiary is free to select. H.R. REP., *supra* note 11, at 94. The option may be illusory, however, since § 668(b)(1) states that the "tax . . . shall be the lesser of" the two and the tax practitioner is under an obligation to minimize his client's taxes. *See* Paul, *The Lawyer as a Tax Advisor,* 25 ROCKY MT. L. REV. 412, 418 (1953); *cf.* ABA CANONS OF PROFESSIONAL ETHICS No. 7. Thus, the tax due under each method must be computed and the alternative which yields the least tax liability chosen. *See also* notes 62, 63 *infra* & accompanying text.

35 *See* IRC § 668(b)(1)(B).

36 H.R. REP., *supra* note 11, at 94; S. REP., *supra* note 11, at 128.

37 The three years used to determine the average annual tax liability are not necessarily the same years to which the distribution is attributed. *See* IRC § 668(b)(1)(B). This is especially true since the new attribution rules start with the earliest years first. *See id.* § 668(b).

38 *Id.* § 668(b)(1)(B).

39 *Id.* § 668(b)(2)(C). The Senate Finance Committee gave the following example:

> For example, if a $10,000 accumulation distribution was made of income accumulated in 10 years, the determination may not include any year in which less than 25 percent of $1,000 ($10,000 divided by 10 years) or $250 was accumulated. For example, if in 2 years less than $250 was accumulated, then, for purposes of the 3-year averaging computation under the short-cut method, the $10,000 would be divided by 8 years (10 years less 2 years disallowed) to determine the average amount deemed distributed each year.

S. REP., *supra* note 11, at 129.

This average yearly distribution of $1250 would then be included in the beneficiary's income for each of the preceding years to determine the additional tax

Under both prior law and the Act, the amount attributable to any one tax year is limited by that year's undistributed net income:[40] distributable net income, including income taxes paid by the trust,[41] less payments distributed or required to be distributed.[42] The taxes are deemed distributed at the trust's average tax rate rather than at the highest rate first.[43] Although this change resulted from a desire to permit easier computation,[44] it will also produce a lower tax credit for the first few times an accumulation distribution is attributable to one tax year.

Several rules cover most of the unusual circumstances likely to arise. If under either the exact or the shortcut method a distribution is attributable to a year in which the beneficiary was not alive, the beneficiary is deemed to have been a single taxpayer having no gross income other than trust accumulation distributions, and no deductions for that year.[45]

A beneficiary of two or more other trusts may not use the shortcut method if, in any year to which an accumulation distribution is attributable, accumulation distributions from the other trusts are also attributable.[46] Multiple distributions from different trusts in the same year are treated as having been made consecutively.[47] The beneficiary is required for all distributions in all years to include amounts previously attributable to a given year when computing his additional tax liability under either method.[48] Trusts which permit the trustees in their dis-

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liability for each year—assume $250, $275, and $225. These amounts would then be averaged to determine the average yearly tax increase—$250. This figure is then multiplied by the number of years involved—eight—to determine the beneficiary's tax liability attributable to the accumulation distribution—$2000.

40 *Compare* IRC § 665(a) *with id.* [O].

41 *Compare id.* § 666(b), (c) *with id.* [O].

42 *Id.* § 661(a).

43 While § 665(a) defines undistributed net income as the amount remaining after income taxes, §§ 666(b), (c), provide that in the case of a distribution equal to or less than the trust's undistributed net income for that year, there "shall be deemed to have [been] distributed" an additional amount, equal to the total, or pro rata share, respectively, of the taxes paid by the trust. This pro rata distribution of the taxes is the trust's taxes for that year, multiplied by the ratio of the accumulation distribution attributable to that year, to the trust's undistributed net income for that year. *Compare id.* § 666(c) *with id.* [O].

44 H.R. REP., *supra* note 11, at 96; S. REP., *supra* note 11, at 131-32.

45 IRC § 668(b)(2)(A). *See* S. REP., *supra* note 11, at 129.

There seems to be a conflict between the legislative history and the words of the statute itself. The statute provides: "that the beneficiary had no [other] gross income . . . and no deductions . . . ." IRC § 668(b)(2)(A). The Senate Finance Committee report permits one personal exemption and the standard deduction. S. REP., *supra* note 11, at 128-29. Perhaps this conflict could be resolved by interpreting the section to mean that the beneficiary's taxable income for that year must be determined under § 63(b), rather than § 63(a). *See also* Elting, *supra* note 33, at 463-64.

46 IRC § 668(b)(2)(B).

47 *Id.* § 668(b)(4).

48 *Id.* § 668(b)(3)(A).

cretion to accumulate or distribute current income are not subject to the throwback rules unless and until the first year of accumulation.[49]

Distributions attributable to previously accumulated capital gains are also subject to the throwback rules if they are: (1) not actually or required to be paid to a beneficiary during the year earned;[50] (2) not paid or permanently set aside for a charitable purpose;[51] and (3) properly allocable to corpus rather than income.[52] The rules for taxing capital gains distributions are similar to those for taxing accumulation distributions[53] and provide for the same special circumstances.[54]

Thus, under the Act's throwback rule, a distribution to a beneficiary falls within one of four categories and in the following order:[55] (1) distribution of current trust income; (2) distribution of accumulated trust ordinary income; (3) distribution of accumulated capital gains from previous years; or (4) distribution of trust corpus. Here again,[56] the first and last items are easily handled, and tax avoidance and recordkeeping problems arise only with regard to accumulated income and capital gains.

The effective date for these new rules was January 1, 1969,[57] with two exceptions: (1) the previous exceptions to the throwback rules, except for the $2,000 exception, are continued until 1974;[58] and (2) capital gains distributions made before 1972 are not subject to the throwback rules.[59] If the taxpayer is a beneficiary of more than one trust (excluding a surviving spouse trust),[60] then this postponement applies to only one such trust.[61]

II. Problems Resulting From Present Law

While the Act broadens the scope of the throwback rule, it makes few fundamental changes in the rule's rationale and purpose. The rule's underlying premise remains: accumulation of income and consequent postponement of taxation to the ultimate recipient at his rate are per-

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49 *Id.* § 668(a). If all of the trust's net income is being currently distributed, then there is no tax deferral problem to prevent taxing the trust as a simple trust. *See id.* §§ 641, 651, 652, & note 1 *supra.*

50 IRC § 665(f)(1)(A).

51 *Id.* § 642(c); *see id.* § 665(f)(1)(B).

52 *Id.* § 665(f)(1).

53 *Id.* § 669(b).

54 *See id.* § 669(c); Elting, *supra* note 33, at 467-74.

55 *See* IRC §§ 665(a), (b), (f), 666(a).

56 *See* text accompanying note 15 *supra.*

57 Tax Reform Act of 1969, § 331(d)(1), Pub. L. No. 91-172, 83 Stat. 598.

58 *Id.* § 331(d)(2)(A).

59 *Id.* § 331(d)(2)(C), 83 Stat. 599.

60 *See* IRC § 2056(b)(5).

61 Tax Reform Act of 1969, § 331(d)(2)(C), Pub. L. No. 91-172, 83 Stat. 599. For 1969, however, the prior law's order of throwback years was retained, *id.* § 331 (d)(2)(B), 83 Stat. 598, perhaps because, as one commentator thought, the tax forms had already been printed at the time the bill was in Congress. Huffaker, *Accumulations Trusts Offer Tax Savings Possibilities Despite New Rules,* 32 J. Tax. 208, 210 (1970).

missible. Consequently, both the old rule's complexity and its greatest tax avoidance problems remain. First, the new rule does not ease the tax practitioner's burden in determining the beneficiary's tax and indeed may increase it. Although the shortcut method was devised to eliminate extensive recordkeeping and computation, and although the committee reports speak of a taxpayer's option,[62] the language of the statute [63] combined with the lawyer's duty to minimize his client's taxes [64] requires computing taxes under both methods when a choice is available and then choosing the method which results in the lower tax liability or greater refund.

Additionally, because both the exact and shortcut methods require inclusion of distributions in the beneficiary's income for prior years at then existing rates, the tax practitioner will have to apply several sets of rates and, perhaps, computation rules. Abrogation of the old five-year limit has added to this task, and the shortcut method, while alleviating some of this additional burden, cannot be used by beneficiaries of multiple trusts.[65]

Secondly, and more important, although present law provides that all trust income must eventually be taxed to the income beneficiary at his marginal rate, the Act continues to afford significant tax incentives to accumulate income because of the time value of money: it is less expensive to pay a dollar in taxes a year from today than it is to pay a dollar in taxes today.[66] If income is accumulated and payment of tax deferred, the trust will have the use of these deferred taxes for investment purposes at the Government's expense.[67] This may be best illustrated by example.

Disregarding differences in tax brackets (and the countervailing imposition on trusts of the most severe rate in general use—that of married individuals filing separately), the device of hybrid treatment allows current income splitting by introducing a new taxpayer. Assume, for example, a single beneficiary has $50,000 in taxable income and an additional $50,000 in taxable income eventually due him from a trust which may distribute now or accumulate. Under current rates if the trust income is distributed during the taxable year the beneficiary will owe about $53,000 in taxes, while if it is accumulated the total tax

[62] H.R. REP., *supra* note 11, at 94; S. REP., *supra* note 11, at 128; *see* note 34 *supra* & accompanying text.

[63] IRC § 668(b)(1) specifically requires that the "tax . . . shall be the lesser of" the two alternatives, whereas § 668(a) [O] merely required the payments to be included in income in the year received. *See* note 34 *supra* & accompanying text.

[64] *See* note 34 *supra*.

[65] IRC § 668(b)(2)(B).

[66] For an introduction to the intricacies of the time-value of money problem and its role in financial investment decision-making, see H. BIERMAN & S. SMIDT, THE CAPITAL BUDGETING DECISION (2d ed. 1966).

[67] These taxes are only paid when the trustee, in his discretion, makes distributions to the beneficiaries in a given year in excess of distributable net income. *See* IRC §§ 661-69; notes 28-44 *supra* & accompanying text.

due now on the same income will be less than $43,000. Thus, $10,000 due the Government may be retained and reinvested until distribution occurs. Applying the same assumptions, but multiplying the number of trusts earning this income, the amount of tax deferred would grow rapidly.[68]

When the difference in tax brackets possible is introduced in this case, the disparity also grows. Assume that the beneficiary has $100,000 of income, and thus a marginal tax rate of seventy percent, before the trust's income is included. Assume still that the trust has taxable income of $50,000, which yields an average tax rate of about forty-five percent.[69] If the trust distributes the income, the beneficiary must return $35,000 in taxes on the distribution. If, however, the trust retains the income, it need return only about $22,500.

Thus $12,500 which will eventually be due the Government has not been paid and is available for current investment—an increase in newly available investment capital from trust income of eighty-three percent after taxes currently due.[70] If the money is retained by the trust for ten years, and the trustee obtains a mere six percent return compounded quarterly, the deferred taxes will earn $10,125, which will inure to the benefit of the trust and, eventually, the beneficiary. At ten percent this figure rises to more than $21,000.[71] Becoming more lucrative as the disparity in rates and number of trusts increase, tax deferral by accumulation in a trust is too profitable to be ignored.

In addition to the possibility of earning income on deferred taxes, the trustee frequently controls the determination whether trust income is taxed in a given year to the trust or the beneficiary and when the additional tax will be paid. Thus, the Government must wait to collect the full tax due on the accumulated income until the trustee decides to distribute. Although the trustee's discretion to accumulate current income may be an important characteristic of trust law, the federal coffers should neither defer to this power nor influence the trustee's decision. The exercise of his discretion should depend insofar as possible only on furthering the grantor's nontax motives.

Present law, however, permits tax avoidance or deferral to influence greatly the grantor's decision to turn to the trust mechanism and the trustee's decision whether to accumulate or distribute in a given year. Most importantly, under present law federal revenue requirements defer to the trustee's determination of when, and therefore the

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68 *See* note 10 *supra*.

69 Under current law the trust's marginal rate would be 62% while it owes $22,590 in taxes, thus having an average tax rate of 45.18%. IRC § 1(d). For simplicity this example ignores the effects of deductions.

70 Of the $50,000, income after taxes due currently increases from $15,000 to $27,500.

71 Of course, the earnings on retained taxes will in turn be subject to taxation at the trust's, and eventually the beneficiary's, rate at the time earned. A substantial benefit remains, however. *See* Surrey, *The Tax Reform Act of 1969—Tax Deferral and Tax Shelters*, 12 B.C. IND. & COM. L. REV. 307 (1971).

rate at which, income will be currently taxed. Thus, the Act, although broadening the scope of the throwback rule, neither eliminates the complexity of the earlier rule nor changes its fundamental concept of permitting the deferral of taxes. The remainder of this Comment seeks a more acceptable alternative to the present trust taxation structure.

III. ALTERNATIVE APPROACHES TO TRUST TAXATION

The problems of hybrid treatment presented in the preceding section might be eliminated by treating the trust either uniformly as a separate taxpayer or uniformly as merely a conduit. Under the former treatment a trust, like a corporation, would pay a tax on income when earned, and the beneficiary would again pay a tax on the income when received. This result could be achieved by merely repealing the deduction presently allowed trusts for distributions to beneficiaries [72] and selecting an appropriate rate, such as that imposed on corporations, to apply to the trust.[73]

Such double taxation, however, would involve a significant reallocation of the costs of government—one rejected in both the enactment and the amendment of the 1954 Code. The American Law Institute in 1953, in proposals that formed the basis of the present Code,[74] summarily dismissed any such policy arguments about Subchapter J:

> Whatever might be the merits of the double tax in the corporate relationship, they clearly do not extend to situations where present and future interests in property are created and the property itself placed in the hands of a caretaker.[75]

Similarly, in its report to the House Ways and Means Committee in 1958, the advisory group on Subchapter J proposed no change in trust taxation policy.[76]

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[72] IRC §§ 651, 661.

[73] This could be done by amending § 641(a) to provide that the tax rate of § 11(a) would apply. *Id.* §§ 641(a), 11(a).

[74] ALI FED. INCOME TAX STAT. (Tentative Draft No. 7, May 1954). Trust taxation was governed by §§ X800-60. *Id.* 406-56.

[75] Holland, *supra* note 1, at 318 (while not an official pronouncement of the ALI, the authors were the Chief Reporter of the responsible Tax Policy Committee, the Associate Chief Reporter, and the two Special Consultants on Trusts & Estates).

[76] ADVISORY GROUP ON SUBCHAPTER J OF THE INTERNAL REVENUE CODE OF 1954, FINAL REPORT ON ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS in *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Comm. on Ways & Means,* 86th Cong., 1st Sess. 257-359 (1959) [hereinafter cited as *Hearings*].

The Advisory Group recommended additional exceptions to the five-year throwback rule, *id.* 301-10, which would have emasculated the rule by increasing the deferral problem the rule was to solve.

The Advisory Group, however, did consider taxing estates which are treated as hybrids, IRC §§ 641, 661, as separate entities. *Hearings* 342-59. The throwback rule, however, does not apply to the distribution of an estate's accumulated income. IRC

While some trusts are now taxed as corporations,[77] this occurs because Congress has defined corporations broadly to include associations,[78] and some trusts meet the Treasury's definition of associations.[79] The distinction thus implemented rests on a policy judgment consistent with that given by the American Law Institute, and articulated more fully in a series of Supreme Court cases decided in 1935:

> "Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—whether created by will, deed, or declaration—by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere *cestuis que trustent,* plan a common effort or enter into a combination for the conduct of a business enterprise. . . . In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains.[80]

Those trusts under which the trustee serves as a mere caretaker or investment manager are given hybrid treatment. Only business trusts are taxed as corporations. The imposition of an additional tax on the grantor's appointment of a caretaker or investment advisor seems an inequitable imposition on the passive income of trust beneficiaries. It may indeed be a privilege to be able to appoint a caretaker or investment advisor for one's property; on the other hand, the sufficiency of this privilege as a basis for imposing an additional tax on the property's income is questionable at best.

Rejecting the double tax in a similar system, the Canadian Royal Commission on Taxation viewed trusts as intermediaries and concluded that the income tax on trusts should be integrated with the

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§§ 665-69 (by implication). *See also* M. FERGUSON, J. FREELAND, & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES (1970). The proposed entity treatment provided for no tax at the beneficiary level, however, so the problem of double taxation did not arise. Still, only two of the nine members of the Advisory Group favored the proposal, and the arguments on both sides merely concerned the alleged prospective hardships practitioners would have in learning and applying the new law. *Hearings* 347-59.

77 Treas. Reg. § 301.7701-4(b) (1960).

78 IRC § 7701(a)(3).

79 Treas. Reg. § 301.7701-4 (1960).

80 Morrissey v. Comm'r, 296 U.S. 344, 356-57 (1935); *accord,* Swanson v. Comm'r, 296 U.S. 362 (1935); Helvering v. Combs, 296 U.S. 365 (1935); Helvering v. Coleman-Gilbert Associates, 296 U.S. 369 (1935).

individual tax;[81] moreover, it reached the same conclusion with respect to the corporate income tax. While the corporate tax was conceded to be "an inexpensive method of collecting taxes,"[82] the incidence of the tax was viewed as borne by others—suppliers, consumers, shareholders, or wage earners.[83] Equity and tax neutrality demanded that even the corporate tax be integrated with the personal income tax.[84] As we shall see, the two significant problems of the current complex trust tax law are unrelated to this decision, and may be solved without changing the policy of taxing trust income only once.

Accordingly, we turn to the other immediately obvious solution to the problems inherent in hybrid treatment: treatment of the trust purely as a conduit—indeed eventual conduit treatment is part and parcel of a policy of taxing only once.[85] The question then becomes when and at what or whose rate the income should be taxed.

The trust could be completely ignored for taxation purposes and its income taxed when earned to either the beneficiary or the grantor.[86] Thus, the trust would be given complete conduit treatment, similar to the treatment of partnerships,[87] and neither deferral opportunities nor recordkeeping problems would arise.

While theoretically feasible, this suggestion must be rejected as a practical alternative. The proposal would require the beneficiary or the grantor, or even the grantor's estate, to use his personal funds to pay the trust income tax attributed to him even though he could not under local trust law demand that the trustee distribute the attributed income.

Present law attributes trust income only in very limited, narrowly defined circumstances as when the grantor has sufficient control over the trust administration, or receives the benefit of the trust income, or does not sever himself from the trust for sufficiently long periods of time.[88] By contrast, this proposal would require personal tax liability in all circumstances, a result which seems too inequitable.

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[81] 4 REPORT OF THE ROYAL COMMISSION ON TAXATION 150-51 (1966). Many of the conclusions reached by the Commission are similar to those reached in this Comment. The similarities and differences are discussed as they arise in connection with the appropriate provisions of the proposal set forth below.

[82] *Id.* 3.

[83] *Id.*

[84] *Id.* 3-4.

[85] Taxation of the trust at a specified rate followed by tax-free distribution to the beneficiary, while appearing similar to entity treatment, is in effect an elimination of one taxable transfer and will accordingly be treated as one form of conduit treatment for present purposes. Its problems are obvious because it is, in effect, the present law without the throwback rule. *See* text preceding note 91 *infra.*

[86] *See* D. SMITH, FEDERAL TAX REFORM 283-98 (1961).

[87] *See* IRC §§ 701-61. To the extent the beneficiaries were unascertainable and trust income taxable to the grantor, the proposal would be similar to the present treatment of grantor's trusts. *See id.* §§ 671-78.

The commentator proposing this treatment suggested that the trust's income usually be taxed to the grantor except when the trust beneficiaries could be definitely ascertained. D. SMITH, *supra* note 86, at 290-98.

[88] *See* IRC §§ 671-78.

Additionally, this proposal could fairly be implemented only prospectively,[89] thus requiring two sets of complex rules operating concurrently for several years, until all now-existing trusts terminate. The implementation of such a dual tax scheme would be an administrative nightmare.[90]

Although it thus appears that income earned by the trust should not be taxed to an individual other than the trust so long as the income remains under the control of the trustee, taxing only upon distribution, whether to the trust, the beneficiary, or the grantor, would be equivalent to using the current hybrid scheme without taxing the trust currently—and would both require recordkeeping and allow complete deferral until distribution. It is necessary that the income be taxed currently if recordkeeping problems are to be avoided, and taxed at least as heavily as it will be taxed ultimately if deferral problems are to be avoided.

The need is thus for a way of taxing the trust, and taxing it during the year in which the income is earned. An independent rate followed by tax-free distribution to the beneficiaries may be rejected summarily—this is the current scheme without the throwback rule, and it would reintroduce the same loopholes.

If tax deferral were the only significant problem with the current throwback rule, the trust might be treated as a withholding intermediary, and current undistributed trust income taxed at the highest individual rate: presently seventy percent.[91] When the accumulated income was later distributed[92] the beneficiaries could gross up the amount reportable to include the tax previously paid by the trust, and receive a credit for the amount of the gross-up representing previously paid taxes.[93] If his marginal rate were less than seventy percent, the beneficiary would receive a refund for the excess.

Under such a scheme, these reportable amounts could be taxed either at the beneficiary's marginal rate in the year distributed or at the beneficiary's marginal rate in the year the trust earned the income. The latter alternative, similar to the present throwback rules except that the trust is no longer taxed as an individual, would reintroduce the onerous recordkeeping requirements and complex computations that trust taxation should seek to avoid.[94]

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[89] D. Smith, *supra* note 86, at 293.

[90] *See* Fillman, *Selections From Subchapter J*, 10 Tax L. Rev. 453, 454 (1955) (proposal requiring the maintenance of two sets of rules applicable concurrently criticized).

[91] IRC §§ 1, 2.

[92] Accumulated income is deemed distributed to the beneficiary whenever the distributions exceed the distributable net income of the trust for that year, as under current law. *See id.* §§ 643, 666, 668.

[93] This would be similar to the credit provided under current law except that no apportionment of the taxes paid by the trust would be necessary, since all taxes would have been withheld at the same rate of 70%. *See id.* §§ 666(c), 667(b).

[94] *See* text accompanying notes 62-71 *supra*.

On the other hand, requiring the entire accumulations distribution[95] to be included in income in the year received by the beneficiary would not be too onerous. The income-averaging provisions[96] could be amended to permit the beneficiary to include these accumulation distributions in his averageable income[97] and average base period income.[98] Permitting the recipient beneficiary to average this income over the allowable five-year period[99] would significantly relieve taxpayers of the "bunching of income" problem without reintroducing the onerous recordkeeping requirements.

While eliminating tax deferral, taxing the trust's undistributed income at the highest marginal rates will, however, unduly influence for tax reasons the trustee's decision whether to distribute or accumulate income in a given year. This result is undesirable, since one of the basic reasons for this proposed reform is to eliminate the influence of tax factors in the creation and continued existence of trusts. This alternative also imposes a hardship on the income beneficiary, because when the tax collected exceeds the tax due computed at the beneficiary's marginal rate the difference is unavailable for reinvestment by the trust.[100] Payment of interest by the Government on the excess tax would be helpful, but could only work if the recordkeeping requirements were reintroduced so as to determine the amount of interest the Government owes on a given distribution.[101]

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[95] The term "accumulations distribution" refers to distribution in a given year of the trust's undistributed taxable income of a previous taxable year. IRC § 666(a).

[96] *Id.* §§ 1301-05.

[97] Averageable income is defined basically as the amount by which the current year's taxable income exceeds 120% of the average income over the four preceding years. It does not include, however, any accumulations distributions made to the taxpayer as a beneficiary of a complex trust. *See id.* § 1302(a).

[98] *Id.* § 1302(b).

[99] *See id.* § 1301.

[100] While tax deferral has been previously criticized, imposition of excess taxes by the Government, even on a temporary basis, is also subject to the same criticism. *See* notes 66-71 *supra* & accompanying text. Further, such a provision might lead to the trustee's distributing all of the income to the beneficiaries currently, perhaps with the understanding either expressed or implied that the beneficiary re-contribute the excess income to the trust.

[101] Even if the beneficiary is ultimately taxed at his marginal rate in the year of the distribution, the recordkeeping is still necessary, because the trust's tax year to which the distribution is attributable must be determined, to allow computation of the proper amount of interest. Of course, if current throwback rules continue to apply, then the prospective beneficiaries must keep records to determine the amount of their refund and the interest due them.

The further question to whom the interest should be payable, still remains. It might be payable to the beneficiary receiving the distributions, on the theory that it was his all along. The interest would then be calculated on the difference between his marginal rate and the 70% withholding rate, for the years the income was accumulated. While feasible and perhaps proper, it does not assist the income beneficiary, for he was deprived of the income from the excess taxes withheld during the years.

Presumably, the income beneficiary was the primary and initial object of the settlor's bounty. Assisting the remaindermen is undesirable if the income beneficiary is deprived of income he would have been otherwise entitled to receive. It might be possible for the government to pay interest to the income beneficiary directly, on the assumption that he would have received the income produced by these withheld taxes. This interest could be calculated on the difference between the income bene-

Having thus rejected taxation of the trust at a rate determined independent of the grantor and beneficiary, we must next consider taxing it currently at a rate derived from the rate applicable to one of these two. The trust could be taxed on the undistributed income but at the grantor's current marginal rate on a grantor-gift theory. Thus, to the extent the trust distributes its income, the gift is complete, and, because the trust property producing this income may be viewed as his property, the beneficiary should pay the tax at his rates. On the other hand, the undistributed income could be viewed as an incomplete gift, and the property producing the income as the grantor's property.

Once the grantor has relinquished control, however, it is apparent to all concerned that the income will eventually inure to the beneficiaries. Because the grantor's rate will be unrelated to that of the beneficiaries, the trustee will be motivated to compare the grantor's rate with theirs and accumulate or distribute to minimize the tax due. Additionally, attribution at the grantor's rate is only possible when the grantor is alive. When the trust is testamentary, or when the grantor of an inter vivos trust has died, a different attribution principle must be used. Attribution at the grantor's marginal rate for the year of his death (or the preceding tax year, to avoid the artificiality sometimes found in a decedent's last return year) is possible, but would be unrealistic. While the trust could be treated as a single taxpayer with no other income, such a proposal would reintroduce the tax avoidance loopholes the throwback rule was designed to eliminate.

IV. Taxation by Rate Attribution

A. *The Proposal*

In terms of the two major problems in current complex trust taxation raised in this Comment, each of the alternatives presented in the preceding section has been shown generally unsatisfactory in solving

ficiary's marginal rate, and the 70% withholding rate. In a discretionary trust, or a discretionary trust involving more than one beneficiary, however, problems arise. There is no guarantee that the additional income from the excess taxes withheld would have been distributed to the income beneficiary, or in what proportion they would have been distributed to the various income beneficiaries. Nor does using the income beneficiary's marginal rate in computing the sum on which the interest should be calculated make sense. The whole problem is that the income is expected to go to beneficiaries other than the income beneficiary.

The government might pay interest, on either the whole 70% or merely the excess taxes collected, to the trust. The former would make the withholding tax merely an investment in government bonds, and would not benefit the government. Indeed, the interest rate might be higher than that generally available.

Under the latter alternative a marginal rate must be chosen. If that of the income beneficiary is used, this withholding tax proposal is equivalent in effect to the rate-attribution taxation scheme suggested below in the text and has the obvious disadvantage of deferring settlement until distribution, thus reintroducing the recordkeeping requirements. If a different rate is used, such as that of a presumed remainderman, then either it is similar to the proposal in the text (in some circumstances) or it is arbitrary.

Therefore, paying interest on the excess taxes solves none of the problems inherent in this alternative.

one or both. Erecting a satisfactory solution for the taxation of complex trusts is primarily a search for the least unsatisfactory scheme, however, and even the solution to be presented here is not free from difficulty. One example may illustrate why no solution can be perfect.

Perhaps the one scheme that would retain Congress's purpose of treating a trust ultimately as a conduit and taxing its income at the beneficiary's rate appears presently impossible to administer. Building upon our present practice of taxing trusts as separate taxpayers on their undistributed income and applying the unlimited throwback rule introduced by the Tax Reform Act of 1969 at the ultimate distribution of this accumulated income, that scheme would require the assessment of an interest charge equal to the rate of compound interest earned by the trust on these deferred taxes. Such a scheme would also have to account for the problem of the deductibility of such an interest charge, determination of the years to which it should be attributed, and the effect of taxes previously paid on the income realized by the trust on these deferred taxes. While a flat interest rate might help solve the problem, its effectiveness would depend upon the actual marginal rate of the beneficiary. As the beneficiary's rate varies, so does the tax differential, and thus the effective rate of the interest charge. Thus, there still remain opportunities for tax deferral.[102] Further, even if technology and information storage reach a level of sophistication and efficiency making this computation economically feasible, difficulty will remain. Either the trust will have been deprived of the use of funds which it might have invested with unknown consequences (if the initial taxes paid by the trust were determined at too high a rate), or the government will have either loaned the trust investment capital at a fixed rate of return or, in essence, adopted the trustee's judgment in the use of its revenues (if the initial taxes were determined at too low a rate). Ignoring administrative costs, perfection is still unattainable.

Short of such an approach, some degree of uncertainty and unevenness of application is inevitable. Primarily, a choice of tax schemes is an effort to balance these factors against the costs of eliminating or mitigating them.

The one trust taxation scheme left to be examined would tax the trust on its income when earned, but at the beneficiary's marginal rate. The beneficiary would no longer be taxed on receipt of trust distributions, except for those made in the year earned. This alternative would eliminate the tax deferral problem which the throwback rule unsuccessfully seeks to solve and would greatly simplify the mechanics of trust taxation. In addition, federal revenues would be collected at the appropriate rate when earned by the trust rather than at a future time determined by the trustee.

[102] The Senate Finance Committee proposed, and the Senate adopted in its version of the Tax Reform Act of 1969, a 3% nondeductible interest charge on accumulations distributions. *See* S. REP., *supra* note 11, at 129-30. This proposal was eliminated in conference, however. CONF. REP. No. 91-782, 91st Cong., 1st Sess. 304-05 (1969).

The onerous recordkeeping required by present law would be alleviated by such a system because the tax would be collected currently at the appropriate rate. Distributions by the trust in excess of distributable net income in a given year would be tax free, because the trust would have already paid the appropriate tax when the income was earned. Current income distributed to the beneficiary would be deductible, as under present law, and would under the conduit principle retain its character in the beneficiary's hands.

Operation of the system would be straightforward. The trustee would notify the beneficiary of his includible share of the trust income distributed or required to be distributed out of current income and of his attributed share of net undistributed income.[103] The beneficiary would then inform the trustee of his tax status: the amount of his taxable income,[104] his method of taking deductions, his filing status, and the number of personal exemptions.[105]

With this information the trustee would determine the tax due on the trust's undistributed net income [106] allocable to each beneficiary. He would determine a total taxable income by adding the beneficiary's share of the trust's undistributed net income and the beneficiary's individual income. He then would determine the tax by subtracting the beneficiary's tax from the tax hypothetically due on the total taxable income. The figure so determined is the trust's tax liability on that beneficiary's attributed share of the trust's undistributed income. The amounts computed for each beneficiary's share would then be totalled to determine the trust's total tax liability.[107]

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103 This is necessary because other trustees involved must be informed if the beneficiary receives income from several trusts. *See* text accompanying note 132 *infra.*

104 The beneficiary's adjusted gross income is also required if the beneficiary claims the standard deduction because the trustee could use any excess standard deduction. *See* note 131 *infra* & accompanying text.

105 The number of personal exemptions claimed is necessary when the beneficiary claims the standard deduction. *See* note 104 *supra;* note 131 *infra* & accompanying text.

106 Undistributed net income is distributable net income less amounts distributed to the beneficiaries. This is similar to its present definition (before the deduction for taxes imposed on the trust). *See* IRC § 665(a).

107 If the beneficiary does not disclose the necessary information to the trustee, his share of the trust income for that and all subsequent years will be subject to tax at 70%. The appropriate adjustment will then be made when the income is paid out to the beneficiary in the future years. *See* text accompanying note 133 *infra.*

The Canadian Royal Commission, in its report, proposed that the beneficiary be responsible for determining the appropriate amount of tax due on his share of the trust's income for that year. 4 REPORT OF THE ROYAL COMMISSION ON TAXATION 171 (1966). While the Royal Commission proposal is feasible, the method suggested in this Comment seems preferable because the trustee is normally responsible for the discharge of the trust's legal obligations and has probably prepared the trust's figures in the first instance. This method, however, might involve some invasion of the beneficiary's privacy. For a possible solution, see text following note 134 *infra.*

The Commission proposed a slightly different method of taxing the income of accumulation trusts. The Commission viewed both the corporate tax and the tax on trusts as a withholding tax with the burden borne by those ultimately receiving the income. The withholding tax on both corporations and trusts was to be 50%—the top individual marginal tax rate. When the income subject to this withholding tax was ultimately distributed to either the shareholder or the beneficiary, a gross-up

Implementation of the system would require that all trusts be placed on a calendar-year accounting period, or on the same fiscal year basis as the principal beneficiaries,[108] and that short term returns be filed during the first year.[109] Because the trust's lowest rate is the beneficiary's marginal rate, this change in accounting periods would be necessary to allow determination of the proper marginal rate and collection of the tax due without delay.[110] In addition, to provide adequate time for the trustee to compute and return the trust's tax,[111] trust returns would be due a short time after individual returns.

B. *Specific Problems and Proposed Solutions*

1. Attribution Rules

Under the proposed system the basic problem is determining to whom and in what proportion the trust income should be attributed, since an appropriate tax rate must be found. When the income beneficiaries are the remaindermen and their respective shares are identified in the trust document, the calculation is straightforward. If, for example, the trust deed empowers the trustee to collect income for the benefit of two beneficiaries in specified proportions, with discretion to distribute or accumulate either beneficiary's share, the trust's distributable net income would first be determined as under current law.[112] Next, each beneficiary's share would be determined by apportioning the trust's distributable net income according to the respective shares. From each share the trust would deduct distributions made to that beneficiary. The tax would then be determined on each share of the undistributed net income by starting at the particular beneficiary's marginal rate, as described above.

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and credit would be permitted. The beneficiary would include the grossed-up amount of income in his tax return for that year, and a credit would be permitted for the taxes already paid by the trust. Any excess taxes paid by the trust would be refundable. *See* 4 REPORT OF THE ROYAL COMMISSION ON TAXATION 149-211 (1966). While feasible, this approach is rejected for American taxation purposes. *See* text accompanying notes 91-101 *supra.*

The beneficiary could elect, however, to have the trust's undistributed income taxed to him at his current marginal rate. 4 REPORT OF THE ROYAL COMMISSION ON TAXATION 169-72 (1966). In order to qualify for this provision, the taxpayer must meet certain conditions demonstrating that he will in all likelihood be the prospective beneficiary. *Id.*

108 As used in the text, the term principal beneficiaries means the beneficiaries receiving the greatest proportion of the trust income, not those entitled to the corpus. A rule similar to the taxable-year rule for partnerships should therefore be adopted for trust taxation purposes. *See* IRC §§ 706(b)(1), (b)(3).

109 *See id.* § 443.

110 If the taxable years of the trust and the principal beneficiaries are not made to coincide, then the trust must either pay its income taxes based upon the previous year of the beneficiary or delay payment of taxes for up to almost a year. *See* IRC §§ 652(c), 662(c).

111 Trusts could also be required to pay their estimated taxes quarterly, thus putting them on the pay-as-you-go basis of most individuals and corporations.

112 *See* IRC § 643(a).

If the trustee has discretion to allocate income among the beneficiaries, determining the appropriate tax rate is more difficult. Each beneficiary's share of the accumulated income cannot be ascertained prior to distribution. The tax, however, is to be imposed during the current year and so cannot be perfectly correlated with the tax which would have been imposed on the beneficiary had he received the income directly. Resort must be had to use of a rule of law or statutory presumption.

Several bases are available for allocating the trust's undistributed net income to the several beneficiaries. The income could be allocated in the same proportion as the distributed income on the theory that the beneficiary receiving the most during the year will most likely receive the same proportion when the current year's undistributed net income is finally distributed. Or the undistributed net income could be allocated in a complementary fashion on the theory that the beneficiary currently receiving the least will receive the largest share when the accumulated income is finally distributed. It is equally likely that the final distribution of accumulated income will be in equal shares. The trust is likely to be designed to terminate when the beneficiaries no longer have special, varying needs.

Choice among these possibilities ought to be made by an informed legislative judgment. At the present time no empirical data attempting to determine which possibility most conforms with reality exist. Armed with such data, and judgments as to what kinds of trust fall into each category, Congress should be able to establish a reasonable rule to be applied with uniformity.

Absent such empirical data, logic dictates that a presumption of equality should be adopted. Tax considerations ignored, discretionary trusts are usually created because of the grantor's uncertainty as to the specific needs of the several beneficiaries. By giving the trustee the requisite discretion, the grantor hopes to accommodate the special, varying needs of each beneficiary. Hence, when the circumstances of each beneficiary change, the trustee will be able to change the income distribution pattern correspondingly. Likewise, the grantor usually designs the trust so that it will terminate when the individual beneficiaries no longer have special, varying needs. Absent specific instructions to the contrary, the trustee will have little incentive at final distribution to discriminate further among the beneficiaries. Therefore, presuming an equal attribution for the undistributed income each year, at least when it is likely to be retained until final distribution, seems most logical, although not absolutely certain.[113]

However, the tax law does not require absolute certainty. For example, the annual accounting concept requires that a decision be made

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[113] The trustee is at all times under a duty of fiduciary responsibility in his administration of the trust, and accountable for breach of this duty in state courts. Thus, were he to favor certain beneficiaries upon the trust's termination without trust language authorizing him to do so, he would face the possibility of a lawsuit. *See* note 117 *infra.*

at the end of each year whether certain incomplete transactions must for income tax purposes be accounted for, even though ultimately it may be that this decision was erroneous.[114] The important consideration in determining whether uncertainty should be tolerated is whether, on balance, the proposal will improve the operation of the revenue laws. Concededly, the proposal discussed herein permits some income to be attributed to a beneficiary different than the one who ultimately receives it, and thus to be taxed at a "wrong" rate, if the present wait-and-see policy is taken as the standard. But the proposal would end the complicated administrative nightmare awaiting tax practitioners and fiduciaries under the current throwback rule, and would eliminate the tax deferral problem. It is submitted that, on balance, the merits of this proposal outweigh the risk of taxing some income at the "wrong" rate.

A reasonable probability test is used under the proposal to determine how much income is to be attributed to each beneficiary. At the end of the year, the income will be attributed to the various beneficiaries in shares which reflect statutory presumptions based upon the reasonable probability of the ultimate disposition of the undistributed trust income. Thus, as discussed above, if no allocation formula is specified in the trust instrument itself, undistributed income will be attributed equally among the several income beneficiaries and taxed to the trust at their individual rates.

If the trust deed specifies an allocation for final distribution, this allocation would be used each year in determining the amount attributable to each beneficiary, even though the allocation may differ from the presumption of equal shares. Here, at the close of each year the reasonable probability will be not that the beneficiaries will share equally in the trust's undistributed net income, but that they will share in the proportions specified in the trust deed.

Some income shifting may still occur even under this taxing scheme. Distributions in excess of distributable net income in a given year, representing undistributed net income of a previous year, are not

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[114] For examples of the decisions forced by the annual accounting requirement, see United States v. Consolidated Edison Co., 366 U.S. 380 (1961); Security Flour Mills Co. v. Comm'r, 321 U.S. 281 (1944); Heiner v. Mellon, 304 U.S. 271 (1938); Burnett v. Sanford & Brooks, 282 U.S. 359 (1931); United States v. Anderson, 269 U.S. 422 (1926).

This annual accounting requirement causes other problems when there exists uncertainty at the end of a taxable year. Rather than altering the annual accounting requirement, the Code provides special rules. When sums are received currently with no restrictions on their uses, they are includible in income even if they must be given back in a later year. The taxpayer is allowed a deduction in the later year. Those taxpayers receiving such sums in later years are accorded similar treatment. *See* IRC § 1341.

When, as a result of the annual accounting requirement, a transaction is taxed in the "wrong" year, and there is a change in the tax rates subsequently, the income has, in effect, been taxed at the "wrong" rate. In this respect, the proposal in the text might cause a similar "wrong" result. It is submitted that both errors are tolerable, since, on balance, both tend to improve, rather than impair, the taxing system.

taxed to the beneficiary, since presumably they have already been taxed at the beneficiary's marginal rate when received by the trust.[115] If, however, these distributions are actually made to a beneficiary other than the one upon whose marginal rate the tax was paid, tax saving may occur, depending upon the relative disparity in marginal rates among the affected beneficiaries.[116] While tax avoidance possibilities remain, however, the opportunity for purposeful tax avoidance is very small, and the obvious cases should be reached directly.[117] Again, the test of reasonable probability at the end of each taxable year justifies

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[115] An exception to this, of course, would be income earned by the trust prior to the adoption of this proposal. Several alternative transitional approaches seem feasible. First, the present throwback rules could continue to apply to all distributions attributable to income accumulated in any tax year prior to the time this proposal is first put into effect. As under current law, distributions would be deemed to be made out of the earliest years first. This would assure that all trust income after 1969 is eventually taxed at the beneficiary's marginal rates. Distributions attributable to tax years after the adoption of this proposal would have been taxed as a trust already and would not be taxed again when distributed to the beneficiary.

The problem with this alternative, however, is that for a period of time dual rules will exist. Additionally, the inclusion of previous years' trust income in a beneficiary's tax return will artificially raise his marginal rates, thus subjecting current trust income to taxation at greater than usual marginal rates.

A second alternative is retroactive repeal of the throwback rules. Thus, for years prior to the adoption of this proposal, the only tax imposed upon trust income would be the tax currently imposed by § 641, as if the trust were an unmarried individual taxpayer. IRC § 641. While this alternative would result in some tax avoidance, it is not the type a taxpayer could manipulate. The loss in tax revenues would undoubtedly be offset by the ease in administration resulting from elimination of dual rules. The marginal rates at which current trust income attributable to the beneficiary is taxed will not be influenced by previous years' distributions. Thus, the temporary tax bonanza would presumably be offset by a savings in administrative costs.

[116] For example, assume that in year 1 the trust has undistributed taxable income of $100,000 and that *A* is deemed to be the beneficiary of that trust. In year 1, *A*'s marginal tax rate is 50%. Therefore, the trust will be taxed at a marginal rate of 50%, or $50,000. Assume that this income is distributed in year 2, but to *B*. *B*'s tax rate in year 1 was 40%. Here, the income has been over-taxed by 10%, or $10,000. This is justified, however, on the basis that at the end of year 1, on all the facts and circumstances, *A* was deemed to be the probable beneficiary of that trust income.

The more likely case, however, is the reverse. This case would often arise when property was left in trust to a decedent's wife for life and, upon her death, to the children. If the wife has little outside income, and the children are grown, then the wife's marginal rate will be fairly low, while the children's rates will be much higher. This will result in under-taxation of the trust income. For example, assume that a trust has undistributed taxable income in year 1 of $100,000, and *W* is presumed to be the beneficiary. Her marginal rate for year 1 is 20%. The trust will pay a tax of $20,000. Suppose the income is distributed in year 5 to *C*, however. *C*'s marginal rate in year 1 was 50%. Here, there has been an under-taxation of the trust income by some 30% or $30,000. Both cases are really extremes. Usually, the person deemed to be the beneficiary will, in fact, receive the distribution of trust income. Even where, however, a different person receives the income, such a disparity in rates as described in these two examples seems to be the exception rather than the rule.

[117] Income attributed to one beneficiary and taxed at his rates under this proposal may actually be received by another beneficiary as a result of one of two occurrences: (1) a change of facts; or (2) a purposeful attempt at tax avoidance. Shifting due to a change of circumstances between the time the income is received and taxed to the trust and the time it is ultimately distributed, is really relatively unpredictable and unlikely to lend itself to calculated tax avoidance. The proposal tolerates this type of income shifting on the theory that when income was received by the trust it was reasonably probable that the original beneficiary would ultimately enjoy that

maintaining the proposed presumption of equality for attributing undistributed trust income to the beneficiaries.

Another attribution problem is presented when the beneficiaries are described as a class. If the class is closed—no more beneficiaries may be added—the problem can be solved by reading the trust as specifying the class members by name and by applying one of the above methods—use of the trust's specific limits on income distribution or allocation among the class members.[118] When the class may vary in size, the reasonable probability test would indicate applying at the end of each taxable year a presumption that the class is closed. At the end of the year, the reasonable probability is that only these members now in existence will share in the trust's undistributed income. The trust's undistributed income would then be allocated in accordance with the guidelines above. While presuming the class closed does not provide certainty, as the discussion above demonstrates,[119] absolute certainty is not required, if, on balance, this uncertainty is outweighed by improvement in the operation of the revenue laws. It is submitted that relieving the Treasury from waiting until the income's distribution or trust's termination to receive the appropriate taxes, as current law requires,[120]

income. This income is viewed as being at his disposal through the operation of the trustee's discretion.

The second circumstance, a purposeful attempt at tax avoidance, cannot be tolerated. This would occur when the trust document appears to provide that several beneficiaries are intended to share in the trust income, but actually only one is to, and does, receive it all. This beneficiary would usually be in a relatively high tax bracket because the rate structure is related to the tax savings and thus the incentive. For example, the trust document might specify that the trustee had the power to distribute the income, in his sole discretion, to the surviving spouse and six (relatively poor) neighbors.

Such attempts to thwart the tax system of this proposal should be fairly obvious. They can occur only in two ways: (1) instructions to the fiduciary in the trust deed itself; or (2) secret instructions to the fiduciary. The first method is easily defeated. As the guidelines described in the text point out, specific provisions in the trust deed override the statutory presumptions, and the proposal would automatically cause the trust income to be attributed to the beneficiaries in the shares provided in the trust document.

When, however, the trustee is given secret instructions, detection at first appears much more difficult. But the trustee has a fiduciary responsibility in the discharge of his duties. Were he to favor any beneficiary, he could be required to account for his decision if pressed by the other beneficiaries. Presumably, such an accounting would be demanded when: (1) the trust fund is sufficiently large; and (2) the wealthiest beneficiary is receiving the funds. Both of these are necessary for significant tax avoidance. *See* note 113 *supra*.

This accountability, and the trustee's presumed ethical and legal conduct, would minimize the frequency of attempts at purposeful tax avoidance in this manner. Further, the Commissioner could be authorized to disregard certain beneficiaries and reallocate the income if the facts disclosed attempted tax avoidance. When avoidance involves fraud, the Commissioner could be authorized to correct the allocation in all previous years without regard for the statute of limitations. This additional weapon should also help to control any attempt to thwart the proposal's operation.

Thus, although some unintentional income shifting is tolerated by this proposal, purposeful attempts to shift the incidence of taxation can be controlled.

118 If any of the members of the class die, then their heirs would be treated as members of the class in such proportions and in such manner as the trust instrument provides. In such a case, the appropriate proportion of the trust income would be taxed to the trust at the heirs' marginal rates.

119 *See* note 114 *supra* & text accompanying notes 114, 115.

120 IRC § 668. *See* text accompanying notes 16, 29-39 *supra*.

sufficiently outweighs the loss of certainty, and any consequent loss of tax revenues, that result from the adoption of this presumption.

Slightly different attribution rules must apply when the income beneficiaries and the remaindermen either differ or share in different proportions. If the income beneficiaries and the remaindermen are the same, and no specific allocation of income is specified in the trust document, then the undistributed income at the end of each year would be attributed either equally, if no corpus allocation were specified, or according to the allocation for final distribution, if one is specified. The reason for this rule is that, in these circumstances, with no other guideline for the income's attribution, the beneficiaries will probably ultimately receive the undistributed income in the same shares as that specified for the final distributions; therefore, applying the reasonable probability test, that allocation formula should control.[121] If, however, the income beneficiaries and the remaindermen are the same, but allocation guidelines are provided in the trust document for both the income distributions and the final distributions (and these allocations are different), then the same rules outlined below for two different groups would apply: the income would be attributed according to the income, not the final distribution, allocation formula. Here, the additional directions contained in the trust document make it more reasonably probable that the beneficiaries will enjoy the undistributed income in accordance with the income allocation formula. As one example, the trust deed might provide that the trust income should be allocated among *X*, *Y*, and *Z* in equal shares, but the trustee may defer distribution of the income in his discretion. At the trust's termination, however, *X* is to receive one-half the corpus, and *Y* and *Z* are each to receive one quarter. For the purpose of the rules outlined below, it will be assumed that individuals other than *X*, *Y*, and *Z* share in the corpus.[122]

When the remaindermen share only in the trust corpus, attribution is simple. The only "income" usually allocated to corpus under local trust law is capital gains.[123] These would be taxed to the trust at the rates attributed to the prospective remaindermen, determined according to the principles discussed above. Undistributed income accumulated for the income beneficiaries would be taxed to the trust at the rates of the prospective income beneficiaries, in the proportion also determined according to principles discussed above.

121 *See* text accompanying notes 112-15 *supra.*

122 As the example demonstrates, this rule would operate very infrequently because it would be very unusual for the trust document to contain such a provision. Further, the operation of this rule is still buttressed by the Commissioner's power to disallow a beneficiary's purported interest for taxation purposes when the facts disclose a purposeful attempt at tax avoidance. *See* note 117 *supra.*

123 RESTATEMENT (SECOND) OF TRUSTS § 233(1)(b) & Comment b (1959); 3 A. SCOTT, THE LAW OF TRUSTS §§ 233.1, 236.12 (3d ed. 1967). The Code implicitly recognizes this fact. *See* IRC § 643(a)(3).

When the remaindermen may also share in undistributed accumulated income[124] remaining at the trust's termination, a more difficult attribution problem arises. Several alternatives suggest themselves: (1) assume all income not currently distributed will be received by the remaindermen; (2) allocate some arbitrary share of the undistributed income each year to each beneficiary class; (3) allocate the undistributed income on a per capita basis to all beneficiaries determined at each year's end; (4) allocate all the undistributed income to the income beneficiaries. The last alternative is preferable for the reasons which follow.

All or some share of the undistributed income could be allocated to the remaindermen on the theory that if the income beneficiaries do not need all the income as it is earned, they probably will not require any excess in the future; this excess will therefore accrue to the remaindermen and should be taxed at their current marginal rate. But there is no reasonable probability that the beneficiaries' needs will not vary from year to year. The grantor probably gave the trustee discretionary power to accumulate or distribute income precisely because he believed that the beneficiaries' needs would vary from year to year, and that the trustee should ensure the sufficiency of available funds to meet these needs. The nontax reasons for creating trusts support this reasoning: providing financial stability and investment management for the beneficiaries. The second and third alternatives should be rejected for the same reasons.

Attributing the trust's undistributed current income to the income beneficiaries can also be supported on practical grounds. First, the class of income beneficiaries will probably already be in existence and readily ascertainable, while the remaindermen may not yet exist. Secondly, the income beneficiaries will receive the excess income immediately, if they need it within the terms of the operative trust deed provisions, while the remaindermen will receive undistributed income only when the trust terminates, regardless of their current needs. Finally, the grantor probably considered the income beneficiaries the more immediate objects of his bounty. Attributing the income beneficiaries' marginal rates to the trust, therefore, seems more sensible and meets the reasonable probability test. This attribution would be done under the applicable guidelines discussed above.

This scheme subordinates to the immediacy of federal revenue needs the absolute certainty of taxing income to the person who actually receives it at his rate. Although the principles outlined above seem involved in description, their application would be quite simple. The applicable rule is determined, and the necessary presumption is applied. The undistributed trust income is then apportioned and taxed at the attributed rate according to that presumption.

[124] For the purposes of this discussion capital gains will be assumed to have already been allocated to corpus for the benefit of the remaindermen.

2. Excess Deductions, Carryovers, and Exemptions

Because the suggested scheme taxes the trust's undistributed income as if actually received by the attributed beneficiary, the question of the proper treatment of the beneficiary's excess deductions and carryovers arises. Except with respect to the beneficiary's standard deduction, the trust should not receive the benefit of these excess deductions. The specific areas affected are excess charitable contributions,[125] net operating loss carryovers,[126] and capital loss carry forward.[127]

To the extent that these deductions are utilized by the trust, they would not be available for the beneficiary to carry over to future years. Although presumably the trust's undistributed income will eventually be distributed to the beneficiary, the timing is not within the beneficiary's control. Thus these deductions will be used to reduce the taxes on income, the economic benefit of which may not inure to the beneficiary's benefit for several years.

If these excess deductions are limited to the beneficiary's actual income without the attributed trust income, they will reduce taxes on income the beneficiary is currently receiving or will receive within the term of the carryover. The beneficiary will use these carryovers to reduce his personal tax burden, not that of a trust in which he may have no voice. Additionally, these deductions arose from his personal, not attributed income; the deductions' tax benefits should inure to his personal benefit.

Similarly, other deductions, such as the drug and medical expense deductions,[128] and the allowable sales tax deductions,[129] which also vary with adjusted gross income,[130] need not change as a result of trust income attribution. The limits on these deductions appear based on an estimate of the expenses which will be incurred at a given level of economic power. Since attributed trust income represents no increase in the beneficiary's immediate economic power, no adjustment should be made in the allowable amount of these deductions.

The standard deduction,[131] however, requires a different conclusion. Because he is allowed no carryover to future years, the beneficiary's economic posture is not adversely affected by allowing the trust the benefit of any unused standard deductions, and the trust should be allowed to use it.

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125 IRC § 170.

126 *Id.*

127 *Id.* § 1212.

128 *Id.* § 213.

129 *Id.* § 164.

130 The foreign tax credit also depends upon the taxpayer's taxable income for the given year. For the reasons stated in the text, it too should not be affected by this rate attribution method, regardless of the fact that the carryover is limited to 5 years. *See id.* §§ 901, 904.

131 *Id.* § 141.

3. Multiple Trusts

The continuing problem of multiple trusts would also be avoided under the proposed scheme. Each trust's undistributed income would be attributed to the beneficiaries currently, at increasing marginal rates in the chronological order of the trusts' creation. Thus, trusts created later for the same beneficiary's benefit would be taxed at a higher marginal rate than an earlier trust. The beneficiary would also be required to report to each trustee all trust income attributed to him by all trusts, and the date of each trust's creation. Each trustee would then pyramid the income of the various trusts to determine the proper tax rate for his particular trust.[132]

Although this scheme pyramids trust income and taxes of the various trusts notwithstanding their creation by different grantors, the result is supportable because had the income actually been received by the beneficiary the graduated rates would apply. The same result should apply when the income is attributed to, but not actually received by, the beneficiary.

4. Miscellaneous Provisions

When the beneficiary refuses to supply the trustee with the requisite information, the undistributed trust income attributable to that beneficiary should be taxed at the highest marginal rates. When the income is distributed, a gross-up and credit should be permitted, as outlined above.[133] The income averaging rules should also apply.[134]

Since this election is available, no invasion-of-privacy objection exists. If, however, this withholding-tax alternative is deemed too onerous, the beneficiary might be permitted to submit the figures to the Treasury and have the Treasury compute the tax and then assess the trust for the computed tax due. Even here, however, there will be an invasion of privacy when the trust has only one attributable beneficiary. It might be possible to permit the beneficiary to pay the taxes on his attributed share personally and request repayment from the trustee periodically, thus masking each year's tax liability by aggregating his claims. The trustee could verify such requests with the Treasury before making payment.

Problems also arise when the beneficiary discloses the required information in some years, but not in others. The beneficiary must then either commit himself to disclosing the information in all years or be ignored when he does disclose it. Vacillation can lead only to intolerable complications and potential tax-avoidance problems.

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[132] In practice this could be accomplished by requiring the beneficiary to send a copy of the form he receives and fills out from each trustee to all other trustees.

[133] *See* note 107 *supra*.

[134] *See* notes 96-99 *supra* & accompanying text.

Auditing would continue to be done, as now, at the individual level. If audit adjustments are made in the beneficiary's return, the trust return would be similarly adjusted.

CONCLUSION

Although the proposal seems complicated, its operation would be both more simple and more straightforward than the current throwback rules. Federal revenue needs would be satisfied when income is earned, not when the trustee distributes. At the same time both the tax-deferral problem and the recordkeeping and extensive calculations presently required would be eliminated. The recurring problem of the proper treatment of multiple trusts would also be solved. And, finally, the congressional choice to tax trust income but once would be retained. Taxation by rate attribution would, thus, much simplify the present complex statutory scheme of trust taxation.

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